FILE COPY

Office-Supreme Court, U.S.
FILED
DEC 24
JAMES ... Clerk

IN THE

Supreme Court of the United States

October Term, 1958

No. 600

WALTER D. HART and JACK HART,
Petitioners,

v.

SELECTED INVESTMENTS TRUST FUND, Linwood O. Neal, Trustee; SELECTED INVESTMENTS CORPORATION, an Oklahoma Corporation; PAUL C. DUNCAN, Trustee in Bankruptcy of Selected Investments Corporation and Selected Investments Trust Fund, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

GEORGE ZOLOTAR,
521 Fifth Avenue,
New York 17, N. Y.,
Counsel for Petitioners.

INDEX

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	3
Statement	3
Reasons for Allowance of Writ	8
Conclusion	19
APPENDIX A—Statutory Provisions	1b
B—Opinions and Orders of Court of Appeals	5b
C—Opinion of State Court	17b

Citations

CASES:

Aughenbaugh, In re, 125 F. 2d 887 (3 Cir.)	15
Bryan v. Welsh, 72 F. 2d 618 (10 Cir.)	10, 18
Caplan v. Anderson, 256 F. 2d 416 (5 Cir.)	15
Consolidated Rock Products Co. v. DuBois, 312 U. S. 510	18
Continental Illinois National Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co., 294 U. S. 648	17
Cook, In re, 104 F. 2d 981 (7 Cir.)	9, 10
Crowell v. Benson, 285 U. S. 22	15
Fidelity Assurance Association v. Sims, 318 U. S. 608	17, 19
Guaranty Trust Co. v. York, 326 U. S. 99	12

PAGE

CASES (Cont'd):

Hawkins v. Board of Control of Florida, 253 F. 2d 752 (5 Cir.) 15

Holmberg v. Armbrecht, 327 U. S. 392 11

Interstate Commerce Commission v. Louisville & Nashville R. Co., 227 U. S. 88 ..... 15, 16

Marine Harbor Properties v. Manufacturers Trust Co., 317 U. S. 78 ..... 14, 17, 19

Mid-Continent Life Insurance Co. v. Goforth, 193 Okla. 314, 143 P. 2d 154 12

Pepper v. Litton, 308 U. S. 295 12

Pope & Cottle Co. v. Fairbanks Realty Trust, 124 F. 2d 132 (1 Cir.) 13

Price v. Gurney, 324 U. S. 100 13

Prudence Realization Corp. v. Geist, 316 U. S. 89 ..... 9, 10

Sampsell v. Imperial Paper & Color Corp., 313 U. S. 215 12

Selected Investments Corporation v. Oklahoma Tax Commission, Okla., 309 P. 2d 267 ..1, 3, 9, 10, 11, 12

Sheridan View Bldg. Corp., In re, 149 F. 2d 532 (7 Cir.) 19

Sims v. Greene, 161 F. 2d 87 (3 Cir.) 15

Stridacchio, In re, 107 F. Supp. 486 (D. N. J.) ... 16

Suburban Properties, In re, 110 F. 2d 438 (7 Cir.) . 17, 18

Taylor v. Standard Gas & Electric Co., 306 U. S. 307 12

Thompson v. Magnolia Petroleum Co., 309 U. S. 478 11

United States v. Abilene & Southern R. Co., 265 U. S. 274 15

Vanston Bondholders Protective Committee v. Green, 329 U. S. 156 9

PAGE

STATUTES:

Bankruptcy Act, 52 Stat. 840, 11 U. S. C. § 1 *et seq.*:
Section 1(8), 11 U. S. C. § 1(8) 13
Section 1(19), 11 U. S. C. § 1(19) 18
Section 2a, 11 U. S. C. § 11a 11
Section 21a, 11 U. S. C. § 44a 16
Section 106(3), 11 U. S. C. § 506(3) 13
Section 130, 11 U. S. C. § 530 ..... 7, 17, 19
Section 137, 11 U. S. C. § 537 ..... 7, 13
Section 141, 11 U. S. C. § 541 18
Section 143, 11 U. S. C. § 543 18
Section 144, 11 U. S. C. § 544 14
Section 145, 11 U. S. C. § 545 16
Section 146(4), 11 U. S. C. § 546(4) 8, 18, 19
Section 161, 11 U. S. C. § 561 7
Section 167, 11 U. S. C. § 567 16

Oklahoma Statutes (1951), Title 71 5

MISCELLANEOUS:

2 Bogert, Trusts (1953) 74, 75, 79 11

Collier on Bankruptcy (14th Ed.):
Vol. 2, page 303 16
Vol. 3, pages 1767-68 (Supp. 1957) 12
Vol. 6, pages 1759-60 14

Fowler, American Investment Trusts (1928) 11

Gerdes, Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act, 52 Harvard Law Review 1 (1938) 16

Hill, The Erie Doctrine in Bankruptcy, 66 Harvard Law Review 1013 (1953) 11

House Report No. 1409, 75th Cong., 1st Sess., p. 42 (1937) 19

Steiner, Investment Trusts, American Experience (1929) 71-3 11

IN THE

Supreme Court of the United States

October Term, 1958

No.

WALTER D. HART and JACK HART,

Petitioners,

v.

SELECTED INVESTMENTS TRUST FUND, Linwood O. Neal, Trustee; SELECTED INVESTMENTS CORPORATION, an Oklahoma Corporation; PAUL C. DUNCAN, Trustee in Bankruptcy of Selected Investments Corporation and Selected Investments Trust Fund, *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above-entitled case on October 14, 1958.

Opinions Below

The District Court for the Western District of Oklahoma wrote no opinion. The opinion of the Court of Appeals, printed in Appendix B, *infra*, pp. 5b-15b, is not yet reported.[1]

[1] For convenience the opinion of the Supreme Court of Oklahoma in *Selected Investments Corporation* v. *Oklahoma Tax Commission*, reported at 309 P. 2d 267 but not officially reported, which petitioners contend is in conflict with the opinion of the Court of Appeals, is printed in Appendix C, *infra*, pp. 17b-26b.

Jurisdiction

The judgment of the Court of Appeals was entered on October 14, 1958 (p. 16b *infra*). Timely petition for rehearing was filed on November 3, 1958 and denied on November 10, 1958 (p. 16b *infra*). On November 25, 1958 the Court of Appeals stayed its mandate pursuant to its Rule 28(3)). The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

Questions Presented

1. Whether, on the issue of the insolvency of a common-law investment trust and its amenability to corporate reorganization proceedings under the Bankruptcy Act, the bankruptcy court may override applicable state law to decide that holders of certificates in the trust are not beneficial owners of proportionate shares of the trust assets but are creditors holding fixed claims against the trust and against its corporate manager.

2. Whether provisions of the Bankruptcy Act according to public investors the express right to file answers controverting the allegations of a petition initiating corporate reorganization proceedings, and requiring the Bankruptcy Court to determine the issues presented by their pleadings, may be so construed as to deprive the investors of the right to offer evidence in support of their pleadings and to permit the bankruptcy court to sustain the petition on the basis solely of evidence submitted by proponents of the petition in the absence of and without notice to the answering parties.

3. Whether proceedings under Chapter X of the Bankruptcy Act, which have the design and effect of ousting a state court of the jurisdiction it is exercising over a wholly-intrastate investment trust, may be sustained if the petition initiating the proceedings does not allege the insolvency requisite for corporate reorganization under the Bankruptcy Act and if the proponents do not under-

take to meet the statutory burden of showing that the interests of creditors and stockholders would not be best subserved in the prior proceedings which are part of the state machinery for such cases.

Statutes Involved

The pertinent provisions of the Bankruptcy Act are set forth in Appendix A, *infra*, pp. 1b-4b.

Statement

These are proceedings for corporate reorganization under Chapter X of the Bankruptcy Act (11 U. S. C. § 501 *et seq.*). There are two debtors: Selected Investments Trust Fund, a common-law investment trust of which Linwood O. Neal is Trustee ("Trust Fund"); and Selected Investments Corporation, an Oklahoma corporation ("the Corporation"). Petitioners are investors in the Trust Fund, owning $34,000 of its certificates (A. 10a).[2]

In *Selected Investments Corporation* v. *Oklahoma Tax Commission*, — Okla. —, 309 P. 2d 267 (1957), reprinted *infra*, pp. 17b-26b, the Supreme Court of Oklahoma had occasion to consider the relationships between the certificate holders and the Trust Fund and between the Trust Fund and the Corporation. It found that the certificate holders were the beneficial owners of the Trust Fund and held that the Trust Fund and the Corporation were separate entities.

---

[2] The record filed herein consists principally of the Appendix to Petitioners' Brief in the court below, the pages to which are referred to as "A. ". Because parties to other appeals, argued together with petitioners' appeals, had already reproduced certain parts of the record in a Transcript of Record (Cases Nos. 5854 and 5950 in the court below), petitioners did not duplicate such parts in their Appendix; that Transcript of Record is also filed herein and page references are shown as "R. ". It is to be noted, however, that except as to the specific parts referred to, the Transcript of Record is not properly a part of the record on petitioners' appeals.

The Corporation, it was found, is a close corporation having a few stockholders and a small board of directors. Its business is the creation and management of investment trust funds. During more than a quarter century of operation in the State of Oklahoma, it created a series of trust funds. There are five series at the present time, collectively known as Selected Investments Trust Fund (R. 19; A. 19a-27a). The trust funds exist pursuant to indentures (R. 170-186; A. 27a-34a), to which there are three parties: (1) the Corporation, which is the organizer (sometimes known as the "depositor") and active manager of the trust fund; (2) the Trustee, who holds legal title to the assets of the Trust Fund, and buys and sells trust assets pursuant to instructions of the manager; and (3) members of the investing public who from time to time invest in the Trust Fund by buying certificates and thereby become the grantors and beneficial owners of the Trust Fund (R. 170; A. 27a-28a).

The certificates were sold exclusively to Oklahoma residents and the proceeds (less initial commissions and selling expenses) were deposited in the Trust Fund and did not become assets of the Corporation (R. 172). Each investor signed a purchase agreement acknowledging that by doing so he became a party to the indenture (R. 10). The certificates, some but not all of which are called "Certificate-Bonds", also provide that the registered holder has become a party to the indenture (A. 19a, 21a, 23a, 25a). Under the terms of the indenture, the holders of the certificates are "grantors of express revocable trusts" (R. 170). If they exercise their option to redeem their certificates, under conditions specified in the indenture, they are entitled to receive their *proportionate share* of the trust fund in cash or in kind (or both) (R. 180-182). This proportionate share may be more or less than the amount, designated in some of the certificates as the "face value" of the certificates, for which the certificate was originally issued (R. 171; A. 23a-27a). Profits earned by the Trust

Fund are distributable to the holders of the certificates in the form of "dividends". (R. 175). The Corporation does not receive compensation for managing the Trust Fund until dividends measured by a specified percentage of the "face value" of the certificates is received by the holders each year (Ibid.).

There is an express disclaimer in the indenture of any liability by the Trustee (or the Corporation) to pay the "face value" of the certificate (R. 182-183). There is no date of maturity. There is no obligation to pay a specified annual return on the investment in the absence of profits. In addition, it is expressly provided that nothing in the indenture shall make the certificate holders creditors of the Corporation (A. 33a).

The Trustee may be removed by vote of the certificate holders as well as by the Corporation (A. 32a). Certificate holders may dissent from amendments to the indenture proposed by the Corporation and may revert to themselves their distributive share of the Trust Fund in the event they disapprove (R. 183).

The operations of the Trust Fund are subject to regulation and supervision by the Oklahoma Securities Commission. Oklahoma Statutes (1951), Title 71.

As stated by the Supreme Court of Oklahoma (309 P. 2d 267, 269):

> "Over the years since 1930 many thousand investors had entered into and contributed to this plan or business venture. Many had received the returns promised at regular intervals and many had cashed out their certificates at a profit. * * * "

Soon after the decision of the State Court, the Commissioner of Internal Revenue, in July 1957, reversed previous positions and ruled that the distributions made by the Trust Fund to the certificate holders would no longer be exempt from Federal income taxation (A. 4a). Pending consideration of the needs presented by this new tax con-

sequence, distributions to and redemptions by certificate holders were suspended (R. 147). This precipitated legal proceedings, among them actions instituted in the Oklahoma State Court in which receivers were appointed pending a recapitalization of the Trust Fund (R. 16-17). In the State Court actions, which are not dependent upon insolvency, the Trust Fund and the Corporation filed a cross-petition and presented a proposed plan of recapitalization (R. 21-26). Hearing on the cross-petition was fixed for March 3, 1958 (R. 17).

On February 27, 1958, with the express purpose of ousting the State Court of jurisdiction, an involuntary petition in ordinary bankruptcy was filed against the Corporation (R. 1-2). The bankruptcy petition was predicated on the assumption that the holders of certificates of the Trust Fund were creditors, rather than beneficial owners in the nature of stockholders, and that the creditor status extended to the Corporation. Admittedly neither the Trust Fund nor the Corporation could be insolvent unless a debtor-creditor relationship was found to exist. At first the Corporation resisted the bankruptcy petition (R. 2, 83-102) but after the District Court insisted that the Trust Fund also be made a party and made known that it was inclined to adjudicate both of them as bankrupts (R. 89-93), despite the conflicting opinion of the Supreme Court of Oklahoma (R. 85), the Trust Fund changed its position and announced that it was prepared to file a voluntary petition for corporate reorganization under Chapter X (R. 103-105). No evidence had been received up to this point; now in an atmosphere free of opposition, brief testimony was introduced on behalf of intervenors supporting the involuntary petition in ordinary bankruptcy (R. 106-116). This was followed by the adjudication of the Trust Fund and the Corporation as bankrupts.

The Trust Fund's petition under Chapter X was then filed and considered (R. 15-17; A. 37a-38a). At the insistence of the District Court, it was subjected to hasty inter-

lineations to convert it into a joint petition on behalf of the Corporation as well as the Trust Fund (*Ibid.*). The petition does not contain any allegation of insolvency or inability to pay debts as they mature, as required by Section 130 of Chapter X (11 U. S. C. § 530), and the balance sheet attached to the petition (R. 19) shows that the Trust Fund has an excess of assets over liabilities of $27,820,201. An order approving the voluntary Chapter X petition and appointing a Trustee was entered immediately; it contained no finding of insolvency or inability to meet debts as they mature (R. 35-38).

As is customary, no notice of the filing and approval of the Chapter X petition was given to the numerous investors holding certificates in the Trust Fund. Their first word of these events was received later as part of the notice of a hearing to consider objections to the Trustee (§ 161, 11 U. S. C. 561; R. 74). Subsequently, Petitioners filed a pleading and answer controverting material allegations of the Chapter X petition (§ 137, 11 U. S. C. 537) and requested dismissal of the proceedings on the grounds that (a) the Chapter X petition did not comply with the requirements of Chapter X, (b) neither the Trust Fund nor the Corporation were insolvent or unable to meet their debts as they matured, (c) the holders of certificates are not creditors of the Trust Fund or the Corporation, (d) the Trust Fund and the Corporation are separate legal entities, and (e) the petition had not been filed in good faith within the meaning of Chapter X (A. 10a-12a). The pleading also joined in and adopted a pleading previously filed on behalf of O'Bryan, O'Bryan & O'Bryan, a law partnership claiming to be a creditor of the Debtors (A. 11a, 1a-10a).

The hearing in the District Court on Petitioners' pleading consisted entirely of colloquy (A. 13a-18a). The proponents of the Chapter X petition did not assume the burden of introducing proof in support of the controverted allegations; instead they immediately presented a previously-prepared order sustaining the petition (A. 15a).

They apparently relied upon the unopposed testimony received in connection with the original bankruptcy petition, of which Petitioners had neither notice or knowledge, but did not produce their witnesses to testify in Petitioners' presence or to be subject to cross-examination. Nor was any oral testimony received on behalf of the objectors to the Chapter X petition (A. 13a-18a, 41a-42a). Orders approving the Chapter X petition, containing findings based on the earlier testimony, were entered by the District Court (A. 18a, 34a-37a).

The Court of Appeals affirmed the orders of the District Court (*infra*, p. 16b). It held that (a) the holders of certificates are creditors of the Trust Fund rather than beneficial owners, (b) the Trust Fund and the Corporation are a single entity, (c) the District Court improperly denied Petitioners an opportunity to adduce evidence in support of the controverted issues of fact raised by their pleadings, but that the error was not prejudicial because of the earlier evidence received from supporters of the Bankruptcy Act proceedings without notice to Petitioners and in their absence, and (d) the voluntary petition under Chapter X did not allege as required by Chapter X that the Debtors were either insolvent or unable to pay their debts as they matured, but the omission was not fatal and insolvency could be inferred (*infra*, pp. 5b-15b). The Court of Appeals did not discuss the good faith requirement of Chapter X [§ 146(4), 11 U. S. C. 546(4)] that pending proceedings should not be removed from state courts unless proponents of Chapter X proceedings assume and sustain the burden of proving that the interests of creditors and stockholders will not be best subserved in the state court proceedings.

Reasons for Allowance of Writ

1. In holding that certificate holders in this conventional common-law investment trust are creditors rather than beneficial owners of proportional interests in the trust property, the court below has decided a matter governed

by state law in direct conflict with the views of the highest state court as expressed in *Selected Investments Corporation* v. *Oklahoma Tax Commission*, — Okla. —, 309 P. 2d 267 (1957). Instead, it has rested its holding on its own notions of federal law. In addition, the decision is in conflict with that of the Court of Appeals for the Seventh Circuit in *In re Cook*, 104 F. 2d 981.

The confusion in this field stems from rulings of the Court on the question of the power of the bankruptcy court to disallow or subordinate claims which are valid under state law. *Vanston Bondholders Protective Committee* v. *Green*, 329 U. S. 156; *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89. In the *Vanston* case, for example, it was said: "In determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits. * * *" (329 U. S. at 162). But in determining whether a claim exists, or whether a claimant is a creditor or a stockholder, the bankruptcy court has no choice but to apply substantive state law and to give effect to state-created rights. Thus, the Court's majority opinion in *Vanston* declared (329 U. S. at 161):

> "* * * What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law. * * *"[3]

[3] In his concurring opinion in *Vanston*, Mr. Justice Frankfurter pointed out (329 U. S. at 169):

> "* * * The existence of a debt between the parties to an alleged creditor-debtor relation is independent of bankruptcy and precedes it. Parties are in a bankruptcy court with their rights and duties already established, except insofar as they subsequently arise during the course of bankruptcy administration or as part of its conduct. Obligations to be satisfied out of the bankrupt's estate thus arise, if at all, out of tort or contract or other relationship created under applicable law. And the law that fixes legal consequences to transactions is the law of the several States. * * *"

And in the *Geist* case, in which federal rules of distribution were applied, the Court called attention to the requirement that bankruptcy courts pay "appropriate regard for rights acquired under rules of state law" (316 U. S. at 95).

The court below has not observed this line of demarcation. It agreed that generally certificate holders in a common-law trust "stand in their relation to the trust much as do stockholders to a corporation", citing the decision of the Seventh Circuit in *In re Cook*, 104 F. 2d 981, and its own decision in *Bryan* v. *Welsh*, 72 F. 2d 618 (*infra* p. 9b). It then proceeded to take the present case out of the general rule, but in doing so ignored the findings of the Supreme Court of Oklahoma with respect to the status of the certificate holders of the very trust with which it was dealing. The State Court, as a result of its examination of "the structure, ownership and operation" of the Trust Fund and the Corporation, concluded (309 P. 2d at 268-269; *infra* p. 19b):

> "* * * Each investor who advanced money to invest in, and thus to build up, 'Trust Fund' was issued a certificate showing his investment, referring to the original trust agreement or indenture and making the investor a party thereto, and thereby *the investor was made an owner of his proportionate share of the 'Trust Fund'*. There was provision for the investor certificate holder to revoke the trust as to his part or share and to withdraw therefrom and to surrender his certificate and receive payment of his share in the fund of the value of his proportionate share at that time. * * *" (Emphasis supplied.)

Time and again, that court referred to "the *beneficial owners* of 'Trust Fund', that is, the certificate holders", emphasizing that its views were predicated not only upon the pertinent contracts—the trust indentures and the certificates—and the business arrangements, but also upon

"the day to day operations" (309 P. 2d at 269, 270; *infra* pp. 20b, 21b, 22b, 24b).[4]

There are now two divergent views as the status of the certificate holders: the view of the Oklahoma Supreme Court that they are beneficial owners of the Trust Fund and the view of the court below that they are creditors. This situation is not to be tolerated. Where a bankruptcy court possesses exclusive jurisdiction to determine a matter of state law, the Court in the past has taken precautions to guard against the possibility that rights dependent upon state law "have—by the accident of federal jurisdiction—been determined contrary to the law of the State, which in such matters is supreme." *Thompson* v. *Magnolia Petroleum Co.*, 309 U. S. 478, 484.

Only on the question whether the Trust Fund and the Corporation are separate entities did the court below take note of the conflicting decision of the State Court (*infra* pp. 6b-7b). But even in this regard the determination of the State Court is overridden in the name of "equitable principles". While it is true that bankruptcy courts are invested with jurisdiction in equity as well as at law (§ 2a, 11 U. S. C. § 11a), this does not mean that they may freely apply federal equitable principles to matters governed by state law. See Hill, *The Erie Doctrine in Bankruptcy*, 66 Harvard Law Review 1013 (1953). Federal equity law is operative as to federal-created rights (*Holmberg* v. *Armbrecht*, 327 U. S. 392) but as to state-created rights equitable principles may not be applied independently of state

[4] While the court below treats the Trust Fund as an exception, the fact is that it is typical of a prevalent type in this country. 2 Bogert, *Trusts* (1953) 74, 75, 79; Steiner, *Investment Trusts; American Experience* (1929) 71-3; Fowler, *American Investment Trusts* (1928). The indentures in the present case are almost a verbatim copy of the model indentures used by Investment Managers Company of New York. See Fowler, *supra*, Appendix C. Accordingly, the decision that certificate holders are not beneficial owners is of substantial importance to investment trusts of the contractual or common-law type.

law. See *Guaranty Trust Co.* v. *York*, 326 U. S. 99. In bankruptcy, consequently, federal equitable principles control the allowability and subordination of claims—as in *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, *Pepper* v. *Litton*, 308 U. S. 295, and *Sampsell* v. *Imperial Paper & Color Corp.*, 313 U. S. 215—but whether there is a claim at all, either legal or equitable, rests upon state determinations at law or in equity. *3 Collier on Bankruptcy* (14th Ed.) 1767-68 (Supp. 1957).

Contrary to the intimation of the court below, the State Court was not powerless in an action at law to disregard the separate entities of the Trust Fund and the Corporation if the circumstances warranted. In *Mid-Continent Life Insurance Co.* v. *Goforth*, 193 Okla. 314, 316, 143 P. 2d 154, 157, it declared that both "law and equity, when necessary to circumvent fraud * * *" treat separate entities as identical. And in the conflicting opinion affecting the present trust, the State Court was urged to ignore the separate entities because the arrangement was a "sham or subterfuge"; it denied the plea not for lack of power at law but because "* * * There is nothing to show that this business method or plan was designed or followed for any wrongful or unwholesome purpose" (309 P. 2d at 270; *infra*, p. 23b).

Nor does the desire to subject the Trust Fund and the Corporation to proceedings under the Bankruptcy Act constitute a justifiable reason for ignoring the separate entities. Both entities were already subject to the jurisdiction of the State Court which was fully competent to prevent fraud, injustice or wrong and to have its receivers pursue remedies against any insiders who may have abused fiduciary obligations. The public certificate holders, who should be the beneficiaries of any disregard of the entities, are not assisted by the determination. In the present case, the major assets are in the Trust Fund and the assets of the Corporation are relatively minor (R. 19, 153). Combining the entities does not improve the position of the certificate holders but rather subjects their assets in the Trust Fund

to the liabilities of the Corporation and thus prejudices the certificate holders for the benefit of creditors of the Corporation.

In holding that the certificate holders were not beneficial owners and at the same time sustaining the Chapter X proceedings, the court below reached a result which is incompatible with the statute. Chapter X is restricted to corporations and the only trusts falling within the statutory definition of "corporation" are those " * * * wherein beneficial interest or ownership is evidenced by certificate or other written instrument". §§ 1(8), 106(3), (5); 11 U. S. C. §§ 1(8), 506(3), (5). If the court below correctly held that the certificates are creditor obligations, then its decision opening the doors of Chapter X to the Trust Fund conflicts in principle with the decision of the Court of Appeals for the First Circuit in *Pope & Cottle Co.* v. *Fairbanks Realty Trust*, 124 F. 2d 132, which correctly applies the definition.

The choice between state and federal law in determining questions as to the existence and allowance of claims is a constantly recurring matter of considerable importance in the administration of the Bankruptcy Act. The decision below is in conflict with the Court's declarations in this general field. However, except for *Price* v. *Gurney*, 324 U. S. 100, which held that state law controlled the question of authority to file a Chapter X petition, there do not appear to have been any definitive determinations as to the applicability of state law to issues arising at the threshold of Bankruptcy Act proceedings, such as the existence of creditor obligations sufficient to create the insolvency essential for the exercise of bankruptcy jurisdiction. This is a matter which should be settled by the Court.

2. The decision of the court below is also of vital importance and prejudice to public investors in countenancing a denial of their right to interpose effective opposition to Chapter X petitions. Despite the approval of a voluntary petition under Chapter X, creditors and stockholders are empowered by the statute to file answers controverting material allegations of the petition (§ 137, 11 U. S. C. § 537).

If this is done, the statute requires that the district judge shall determine "the issues presented by the pleadings" and whether "the material allegations are sustained by the proofs" (§ 144, 11 U. S. C. § 544). The statutory scheme has been described as follows (6 *Collier on Bankruptcy* (14th Ed.) 1759-60):

> "When the petition is duly challenged by answer, the judge of the reorganization court is required by § 144 to determine (1) whether the petition complies with the requirements of Chapter X, (2) if it has been filed in good faith, and (3) if its material allegations are sustained by proofs. As under § 143, *such a determination may be made only after both parties have been given an opportunity to be heard.* • • • The burden is on the petitioner or petitioners, as the case may be, to uphold the petition; and if the petition does not meet the requirements of Chapter X, or if there is a failure of proof to sustain the material allegations of the petition or to satisfy the judge regarding the good faith thereof, the petition must be dismissed • • • " [Emphasis supplied].[5]

The right to a hearing is meaningless if those granted the right are bound by the evidence received in their absence and by determinations made at earlier hearings to which they were not parties. Yet because evidence had been adduced *prior* to the filing of the Chapter X petition by proponents of the Bankruptcy Act proceedings, and although no evidence in *opposition* to the Chapter X petition had ever been received, the court below held that there was no prejudice. Clearly, due process requires that the public investors to whom Congress has granted the right to controvert Chapter X petitions must be afforded the opportunity (a) to contest the evidence submitted by the proponents of the Chapter X petition, (b) to cross-examine witnesses supporting the petition and (c) to offer evidence and witnesses supporting their objections. No assumption can be made that the results would remain

[5] The statement that the burden is on the proponents of the petition is based on *Marine Harbor Properties* v. *Manufacturers Trust Co.*, 317 U. S. 78, 83, 85. The burden was not assumed here.

the same until the objections, the cross-examination and the counter-proof have been received and considered.[6]

In non-bankruptcy contexts, other Courts of Appeals have emphasized that one-sided evidence will not support a judgment. *Sims* v. *Greene*, 161 F. 2d 87 (Cir. 3); *Hawkins* v. *Board of Control of Florida*, 253 F. 2d 752 (Cir. 5). In the *Sims* case, the Third Circuit said (at pp. 88, 89):

> "* * * Trial of an issue of fact necessitates opportunity to present evidence and not by only one side to the controversy. * * *
>
> * * *
>
> "* * * Finding facts requires the exercise by an impartial tribunal of its function of weighing and appraising evidence offered, not by one party to the controversy alone, but by both. * * *"

In a bankruptcy proceeding, the same court set aside a determination of insolvency which was based not on testimony adduced in the presence of the parties but on earlier testimony and documents on file in the same proceeding. See *In re Aughenbaugh*, 125 F. 2d 887 (Cir. 3), relying on this Court's rulings as to hearings before administrative agencies in *Interstate Commerce Commission* v. *Louisville & Nashville R. Co.*, 227 U. S. 88, 93 ("* * * manifestly there is no hearing when the party does not know what evidence is offered or considered, and is not given an opportunity to test, explain, or refute. * * *"); *United States* v. *Abilene & Southern R. Co.*, 265 U. S. 274; and *Crowell* v. *Benson*, 285 U. S. 22, 48. *Cf. Caplan* v. *Anderson*, 256 F. 2d 416 (Cir. 5).

---

[6] As there was no disclosure, and none was required, of what the objectors intended to prove, there is no basis for the lower court's speculation that what they "* * * might have presented would have been merely cumulative and repetitive * * *" (*infra*, p. 15b). To the contrary, the objectors' purpose in challenging the proceedings was based on their disagreement with what had transpired earlier. They complied with the statute by filing their pleadings; nothing more was required of them until the trial and this, the court below agreed, was never held (*Ibid.*).

The untenable character of the decision below is emphasized by Section 145 of Chapter X, 11 U. S. C. § 545. Under that section, a determination resulting from the trial of an issue presented by the answer of one party is not conclusive upon other parties entitled to file answers unless they have been given notice of the hearing. See Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act*, 52 Harvard Law Review 1, 7 (1938). In the present case, the only previous determination occurred in connection with the approval of the voluntary Chapter X petition. No general notice of that filing was given and none was required. Accordingly, Petitioners were not notified and did not attend the hearing on the voluntary petition; as to them, the approval was entered *ex parte*. Their first notice was after the approval of the Chapter X petition when they were advised that a trustee had been appointed. Prior to the filing of Petitioners' pleadings, there had been no trials of issues presented by any answers, and the hearing on their pleadings was the first opportunity to present evidence in opposition to the Chapter X petition. That right was denied and there was no other opportunity to "test, explain or refute". (*Interstate Commerce Commission* v. *Louisville & Nashville R. Co.*, 227 U. S. 88, 93). As a result, the affirmance of the District Court rests exclusively on meagre one-sided testimony (R. 106-117)[7].

[7] Some of the facts recited in the opinion of the court below are derived from testimony elicited in *ex parte* fishing expeditions permitted by Sections 21a and 167, 11 U. S. C. §§ 44a, 567. See *infra* pp. 7b-8b. These examinations (R. 117-144), which were conducted by the Chapter X trustee after his appointment, were not in existence when the Chapter X petition was approved and formed no part of the record upon which the District Court acted. Moreover, the examinations being purely investigatory and exploratory, no findings were ever made in the District Court on the basis of their content. Some of the appellees, however, predicated their contentions on these examinations, as though they constituted testimony at a contested trial, and may do so again in opposition to petitioners. But see *In re Stridacchio*, 107 F. Supp. 486, 488 (D. N. J.); 2 *Collier on Bankruptcy* (14th Ed.) 303.

The question presented is of importance in the administration of Chapter X of the Bankruptcy Act. The Congress has granted public investors the unrestricted right to contest Chapter X petitions initiated or acquiesced in by management as a safeguard for the protection of their investments and in pursuance of a policy of democratizing corporate reorganization proceedings by broadening avenues for investor participation. The decision of the court below frustrates that policy and also sanctions an extraordinary departure from the accepted and usual course of judicial proceedings.

3. In sustaining the Chapter X petition in the face of its patent deficiencies and the failure of the proponents to establish good faith in the filing of the petition, the decision of the court below conflicts in principle with the decision of the Court of Appeals for the Seventh Circuit in *In re Suburban Properties*, 110 F. 2d 438, and is indirect conflict with the decisions in *Marine Harbor Properties* v. *Manufacturers Trust Co.*, 317 U. S. 78, and *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608.

a. Section 130 of the Bankruptcy Act, 11 U. S. C. § 530, requires every Chapter X petition to state "that the corporation is insolvent or unable to pay its debts as they mature." This requirement is essential to bring statutory reorganization procedures within the bankruptcy clause of the Constitution. See *Continental Illinois National Bank & Trust Co.* v. *Chicago, Rock Island & Pacific Ry. Co.*, 294 U. S. 648, 667-675. The Chapter X petition in the present case does not contain any allegation of bankruptcy or equity insolvency (R. 15-19). This is not mere inadvertence, but a reflection of the firm belief of the management of the Trust Fund and the Corporation that they were quite solvent. In addition to omitting the customary allegation of insolvency, the Chapter X petition alleges (R. 16): "The assets and liabilities of the Trust Fund are reflected and shown by Exhibit A. * * * " Exhibit A, a balance sheet, lists assets of $28,848,791, liabilities of only $1,028,590 and

an equity for certificate holders of $27,820,201 (R. 19). To this demonstration of solvency the petition adds (R. 16): "* * * The true value as a going concern will greatly exceed that shown by Exhibit A * * *." The initial order of approval also contained no finding of insolvency (R. 35-38).

"It is elementary that the petition must set forth the essential facts. * * *" *In re Suburban Properties*, 110 F. 2d 438, 440 (Cir. 7). In that case, a Chapter X petition was dismissed because it lacked "the story of the debtor's financial condition, its need for reorganization, and the possibility of effecting the same" (*Ibid.*). *In Bryan v. Welsh*, 72 F. 2d 618, the court below ruled that an *allegation* of insolvency or inability to meet debts was an indispensable requisite to bring an alleged debtor within the reorganization sections of the Bankruptcy Act; its omission was fatal. It is no less indispensable here. A petition which does not comply with the statute must be dismissed. §§ 141, 143, 11 U. S. C. §§ 541, 543.[9]

b. A Chapter X petition is not filed in good faith if "a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding." § 146(4), 11

---

[8] The opinion of the court below seems to imply that the balance sheet shows liabilities of $39,038,139.91 (*infra* p. 13b). That figure appears as the "face amount" of the outstanding certificates; the "Certificate Holders' Equity" is listed as $27,820,201.06, a figure derived by deducting liabilities of $1,028,590 from assets of $28,848,791 (R. 19).

[9] It is to be noted that the record does not contain a word of *testimony* on the issue of insolvency and that this was a major item in the matters as to which the objectors desired to offer proof (R. 106-117; A. 1a-2a, 7a-12a). In fact, the objectors claimed that they could show solvency even if the certificate holders were deemed to be creditors (A. 1a-2a, 7a-10a). It is the fair valuation of the assets on a going concern basis, not their book or liquidation value, which determines whether there is an excess of assets over liabilities. § 1(19), 11 U. S. C. § 1(19); see *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510.

U. S. C. § 546(4). In *Marine Harbor Properties* v. *Manufacturers Trust Co.*, 317 U. S. 78, 84, it was held that this provision and the requirement of § 130(7), 11 U. S. C. § 530(7), that every Chapter X petition make a showing of "need for relief", imposed a burden upon proponents of Chapter X petitions to demonstrate "that at least in some substantial particular the prior proceedings withhold or deny creditors or stockholders benefits, advantages, or protection which Ch. X affords". The purpose of § 146(4), it was pointed out, was to "stop the removal of prior pending cases from other courts where the interests of creditors and stockholders would be better served by retaining and continuing the prior proceedings" House Report No. 1409, 75th Cong., 1st Sess., p. 42 (1937). This Congressional policy was also enforced in *Fidelity Assurance Association* v. *Sims*, 318 U. S. 608, 619, resulting in the dismissal of a Chapter X petition for an investment company subject to state court receivership proceedings.

Here, no effort was made in the Chapter X petition or at the hearing to consider its approval to meet this good faith requirement. In the absence of evidence, the district judge may not assume that the prior proceeding is inadequate. *In re Sheridan View Bldg. Corp.*, 149 F. 2d 532 (Cir. 7). Adherence to good faith standards in this regard is essential to the integrity of the reorganization process as administered in the federal courts.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

GEORGE ZOLOTAR,
Counsel for Petitioners.

December, 1958.

APPENDIX A

Statutory Provisions

The following provisions of the Bankruptcy Act (52 Stat. 840, 11 U. S. C. § 1 *et seq.*) are pertinent to the questions presented by this petition.

Section 1(8) (11 U. S. C. § 1(8)):

"Corporation" shall include all bodies having any of the powers and privileges of private corporations not possessed by individuals or partnerships and shall include partnership associations organized under laws making the capital subscribed alone responsible for the debts of the association, joint-stock companies, unincorporated companies and associations, and any business conducted by a trustee or trustees wherein beneficial interest or ownership is evidenced by certificate or other written instrument;

* * * *

Section 2 (11 U. S. C. § 11):

a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—

* * * *

Section 106 (11 U. S. C. § 506). For the purposes of this chapter, unless inconsistent with the context—

(1) "claims" shall include all claims of whatever character against a debtor or its property, except stock, whether or not such claims are provable under Section 63 of this Act and whether secured or unsecured, liquidated or unliquidated, fixed or contingent;

* * * *

(3) "corporation" shall mean a corporation, as defined in this Act, which could be adjudged a bankrupt under this Act, and any railroad corporation excepting a railroad corporation authorized to file a petition under Section 77 of this Act;

(4) "creditor" shall mean the holder of any claim;

(5) "debtor" shall mean a corporation by or against which a petition has been filed under this chapter;

(6) "debts" shall include all claims;

* * *

(12) "stock" shall include membership, shares, and similar interests in a debtor, certificates and other evidences of such membership, shares or interests, and voting-trust certificates;

* * *

Section 130 (11 U. S. C. § 530). Every petition shall state—

(1) that the corporation is insolvent or unable to pay its debts as they mature; (2) the applicable jurisdictional facts requisite under this chapter; (3) the nature of the business of the corporation; (4) the assets, liabilities, capital stock, and financial condition of the corporation; (5) the nature of all pending proceedings affecting the property of the corporation known to the petitioner or petitioners and the courts in which they are pending; (6) the status of any plan of reorganization, readjustment, or liquidation affecting the property of the corporation, pending either in connection with or without any judicial proceeding; (7) the specific facts showing the need for relief under this chapter and why adequate relief cannot be obtained under chapter XI of this Act; and (8) the desire of the petitioner or petitioners that a plan be effected.

* * *

Section 137 (11 U. S. C. § 537). Prior to the first date set for the hearing provided in section 161 of this Act, an answer controverting the allegations of a petition by or against a debtor may be filed by any creditor or indenture trustee or, if the debtor is not insolvent, by any stockholder of the debtor.

* * *

Section 141 (11 U. S. C. § 541). Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied.

* * *

Section 144 (11 U. S. C. § 544). If an answer filed by any creditor, indenture trustee, or stockholder shall controvert any of the material allegations of the petition, the judge shall, as soon as may be, determine, without the intervention of a jury, the issues presented by the pleadings and enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith and that the material allegations are sustained by the proofs, or dismissing it if not so satisfied.

Section 145 (11 U. S. C. § 545). If any issue raised in an answer filed under section 136 or 137 of this Act has, after hearing upon notice to the debtor, creditors, indenture trustees, and stockholders entitled to controvert the allegations of the petition, already been tried and finally determined under the provisions of section 143 or 144 of this Act, such final determination shall be conclusive for all purposes under this chapter.

Section 146 (11 U. S. C. § 546). Without limiting the generality of the meaning of the term "good faith", a petition shall be deemed not to be filed in good faith if—

(1) the petitioning creditors have acquired their claims for the purpose of filing the petition; or

(2) adequate relief would be obtainable by a debtor's petition under the provisions of chapter XI of this Act; or

(3) it is unreasonable to expect that a plan of reorganization can be effected; or

(4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.

* * *

Section 161 (11 U. S. C. § 561). The judge shall fix a time of hearing, to be held not less than thirty days and not more than sixty days after the approval of the petition, of which hearing at least thirty days' notice shall be given by mail to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission and such other persons as the judge may designate, and, if directed by the judge, by publication in such newspaper or newspapers of general circulation as the judge may designate.

* * *

APPENDIX B

Opinion and Orders of Court of Appeals

WALTER D. HART, *et al.*

v.

PAUL C. DUNCAN, Trustee, *et al.*

Nos. 5975, 5976

(October 14, 1958)

Before:

BRATTON, *Chief Judge* and PICKETT and BREITENSTEIN, *Circuit Judges.*

BRATTON, *Chief Judge:*

For convenience, reference will sometimes be made to Selected Investments Corporation as the Corporation and to Selected Investments Trust Fund as the Trust Fund. A petition in involuntary bankruptcy was filed against the Corporation. The Corporation answered; a hearing was had; and an order of adjudication was entered. The Corporation and the Trust Fund filed a joint petition for reorganization under Chapter X of the Bankruptcy Act, as amended, 52 Stat. 883, 11 U. S. C. § 501, et seq. Treating the Corporation and the Trust Fund as a single entity, the court approved the petition for reorganization; appointed a trustee; authorized the trustee to operate the business assets, property, and affairs of the debtor; stayed the proceedings in involuntary bankruptcy; and stayed all other proceedings affecting the estate of the debtor. Asserting that they were creditors of the debtor, various owners and holders of certificates issued by the Corporation and countersigned by the trustee of the Trust Fund intervened

in the reorganization proceeding. Asserting that it had an unpaid claim against the debtor for professional services rendered, the firm of O'Bryan, O'Bryan & O'Bryan filed in the proceeding a petition to vacate and dismiss. The prayer of the petition was that a hearing be had thereon; that the adjudication in bankruptcy be vacated; and that the petition for involuntary bankruptcy be dismissed. And asserting that they owned and held certificates issued by the Corporation and countersigned by the trustee of the Trust Fund, Walter D. Hart and Jack Hart filed in the proceeding a pleading denominated Certificate Holders' Joinder, Petition and Answer to Dismiss Debtors' Petition under Chapter X. In such pleading, it was pleaded among other things that the petitioners joined in and adopted the petition of the O'Bryans. The prayer was that the involuntary petition in bankruptcy be dismissed; that the order approving the petition for reorganization be vacated; and that the petition for reorganization be dismissed. The pleading filed by the O'Bryans and that filed by the Harts, respectively, were denied. These several appeals in their totality bring here for review the order of adjudication, the order approving the petition for reorganization, the order denying the pleading filed by the O'Bryans, and the order denying the pleading filed by the Harts. The cases were argued together and disposition may be made of them in like manner.

The action of the court in treating the Corporation and the Trust Fund as a single entity is challenged. It is argued that the question whether the two are a single entity or separate entities must be determined by the law of Oklahoma, and that under the law of that state they are separate entities to be dealt with in that manner. The case of Selected Investments Corp. v. Oklahoma Tax Commission, — Okla. —, 309 Pac. (2d) 267, is relied upon to sustain the contention. That was an action for refund of income tax paid under protest. The ground of attack upon the tax was that

the Corporation and the Trust Fund were separate legal entities; that the income involved constituted income to the Trust Fund; and that therefore the Corporation was not liable for the tax. It was held that the Corporation and the Trust Fund were separate legal entities; that the items of income involved constituted income to the Trust Fund; that they were not taxable as income of the Corporation; and that therefore the Corporation should prevail. But that was an action at law. Equitable principles did not control. It is the general rule both in actions at law and in proceedings in equity that existing separateness of legal entities will be respected and preserved. But in an equitable proceeding, the fiction of separate entities may be disregarded and two or more entities treated as one when it becomes necessary to do so in order to prevent fraud, injustice, or wrong. That general rule is frequently applied in determining the separateness of identity of a corporation and its members. Fitzgerald v. The Central Bank & Trust Co., 257 F. (2d) 118. But it is not limited in application to instances of that kind. It has appropriate application in determining whether under the facts and circumstances in these cases the separateness of entities of the Corporation and the Trust Fund should be disregarded as a means of preventing fraud, injustice, or wrong.

These facts and circumstances should be brought into focus in determining whether the court providently disregarded the separateness in legal entity of the Corporation and the Trust Fund and treated the two as a single entity. The Corporation was organized under the law of Oklahoma in December, 1930. A trust indenture was entered into in January, 1931. Provision was made in the indenture for the formation of the Trust Fund as an unincorporated entity, and Security National Bank of Norman, Oklahoma, was named as trustee. The Corporation and the Bank executed the instrument as parties thereof. The indenture contemplated that certificates of indebtedness

would be issued by the Corporation, countersigned by the trustee of the Trust Fund, and sold to investors in Oklahoma; that the funds paid by the investors would be placed in the assets of the Trust Fund; and that the funds would be invested in stocks, bonds, and other securities. The indenture vested in the Corporation full power to issue and sell the certificates, and to manage and control the trust. For about ten years immediately preceding the intervention of receivership in the state court, Linwood O. Neal was trustee of the Trust Fund. But he was merely an empty figure. He was the nominal custodian of the assets of the Trust Fund but he did nothing except to receive funds and disburse them upon the direction and at the command of the Corporation. He was selected as trustee by the Corporation; was subject to removal by the Corporation; and was completely subservient to the control and direction of the Corporation. Hugh A. Carroll, president of the Corporation, completely dominated and controlled both the Corporation and the Trust Fund. And the affairs of the two were managed at least in part for the financial benefit of Carroll, his wife, and a few close associates. The pattern employed in several instances in managing the affairs of the Corporation and the Trust Fund for the financial benefit of Carroll, his wife, and one or more close friends, was to cause funds to be siphoned from the Trust Fund to the Corporation, cause the funds to be passed on to satellite corporations organized or acquired and financed in part with such funds, and then cause the satellite corporations to pay salaries to Carroll, his wife, and the friend or friends ostensibly as compensation for services in the form of advice and supervision. In one instance, a large amount of cash was siphoned from the Trust Fund to the Corporation and then paid by the Corporation direct to Carroll in the form of a loan. And most of the debt remained unpaid at the initiation of bankruptcy. The action of the court in disregarding the separateness of legal identity of the

Corporation and the Trust Fund as a means of preventing fraud, injustice, and wrong rested upon solid equitable basis and therefore should not be disturbed on appeal.

The pivotal question to which the contending parties direct with vigor much of their argument is one of jurisdiction of the court to proceed with the reorganization proceeding. The question is whether at the time of the filing of the petition for reorganization, the debtor was insolvent or unable to meet its debts as they matured. And it turns upon whether the relationship of debtor and creditor existed between the debtor and the holders of certificates issued to investors. It is clear that if such relationship did exist, the debtor was insolvent and the court was clothed with jurisdiction to proceed with the reorganization. On the other hand, if the holders of the certificates were merely beneficial owners of proportional shares of the assets of the Trust Fund, the debtor was not insolvent and therefore the court lacked jurisdiction. It is well settled that certificate holders in a conventional common-law trust stand in their relation to the trust much as do stockholders to a corporation. In ordinary circumstances, they are not creditors of the trust. Instead, they are equitable owners of proportional interests in the trust property. *Bryan* v. *Welsh*, 72 F. (2d) 618. *In re Cook*, 104 F. (2d) 981.

But this business enterprise did not fall within the range of that general rule. As organized, maintained, and operated throughout the twenty-nine years which intervened between the organization of the Corporation and the formation of the Trust Fund, and the initiation of receivership proceedings in the state court, the enterprise bore characteristic earmarks which clearly distinguished the relationship existing between the certificate holders on one hand, and the Corporation and the Trust Fund on the other hand, from that usually existing between holders of ordinary certificates and conventional common-law trusts. The trust indenture authorized the Corporation to issue certificates

of the face value of $100 or multiples thereof and to sell them to investors. It provided that the trustee of the Trust Fund should authenticate the certificates and deliver them to purchasers upon the written order of the Corporation and upon payment therefor. It made provision for the redemption of the certificates at the election of the Corporation, or at the election of the holders at any time after three years from issuance. The certificates were to be redeemed in cash, or in kind, or both, the holder to receive his aliquot share of the total valuation of the fund, determined by reference to the face of the certificate. The indenture provided that there was no liability to redeem certificates at their face value. It further provided that the Corporation and the Trust Fund should not be obligated in respect to the certificates except as expressly provided in the indenture. It empowered the Corporation to declare the existence of emergencies and to suspend the redemption of certificates during such emergencies. And it further empowered the Corporation to charge and receive commissions, expenses, and compensation for services, but withheld the right to compensation for managing the fund until the annual returns were paid to the investors. While each investor was required to sign a purchase agreement in which it was stated among other things that by accepting the certificate the investor became a party to the trust indenture, there is no indication in the record that investors were furnished copies of the instrument, or were familiar even in a general way with its provisions, or had any information respecting its restrictive provisions. Instead, it is a fair inference from the record as a whole that investors were unfamiliar with the terms and provisions of the indenture. At least five series of certificates were issued, denominated series A, E, F, G and O, respectively. In the certificates, the distribution of returns to the holder was referred to as dividends; and the right of the holder

upon redemption was referred to as his distributive share of the assets of the Trust Fund. On their face, the F and G certificates were denominated investment trust certificates; and throughout they were called certificate or certificates. The series O certificates were labeled on the outside "Certificate-Bond". Near the top of the face of the certificates appeared "No. Shares .....". And at a nearby position appeared "Face Value Dollars $.....". The hyphenated word "certificate-bond" appeared twenty-four times in the face and on the reverse side of the certificates. The single word "bond" appeared twice. And the word "bondholders" appeared once. By and large, the certificates in series A were similar except in respect to rate of return. The series O certificates provided that no past, present or future stockholder, member, officer, or director of the Corporation should be personally liable under "this Certificate-Bond or under the Indenture". But such provision of immunity from personal liability did not expressly include the Corporation itself.

It was the general practice in the selling of the certificates to tell investors that they were lending money; that they were receiving bonds with a fixed rate of return; and that after three years from issuance of the bonds, the investors could cash them at their face value. And until shortly before the intervention of receivership proceedings in the state court, annual payments were regularly made to investors. The Corporation considered and treated such payments as interest. The payments were at the rate of six per cent per annum; and they were consistently made without regard to fluctuations in earnings or losses. Some of them were made out of capital, not earnings. And all certificates which had been outstanding for more than three years were redeemed in cash at their face value if demand therefor was made by the holder without valuation or determination of the distributive share of such holder in the trust fund. Shortly before the initiation of receiver-

ship proceedings in the state court, the Corporation failed for the first time to make the usual annual payment to holders of certificates representing a return of six per cent upon the face value of the certificates; it also declared an emergency and discontinued the redeeming of certificates until a reorganization could be effectuated; and that precipitated legal proceedings.

Section 106(1) of Chapter X, *supra*, 11 U. S. C. § 506(1), defines "claims" to include all claims of whatever character against a debtor or its property, except stock, whether or not provable under section 63, and whether secured or unsecured, liquidated or unliquidated, fixed or contingent; section 106(4), 11 U. S. C. § 506(4), defines "creditor" to mean the holder of any claim; and section 106(6), 11 U. S. C. § 506(6), defines "debts" to include all claims. The provisions of the trust indenture; the appearance, contents, and provisions of the certificate; the practices, procedures, statements, and representations made to investors in connection with the sale of certificates; the payment of annual returns, which the Corporation and the Trust Fund considered and treated as interest, without regard to fluctuations in earnings or losses, and without regard to whether made out of earnings or capital; and the consistent redeeming of certificates at their face value without valuation or determination of the distributive share of the holder thereof in the Trust Fund, all co-acting and combined, had the effect of creating the relationship of debtor and creditor between the Corporation and the Trust Fund on one hand, the holders of certificates on the other hand, rather than that of the holder of certificates merely owning interests in or shares of the assets of the Trust Fund. Since the relationship existing between the parties was that of debtor and creditor, the holders of certificates had claims of personal liability at the face value of the certificates against the Corporation and the Trust Fund which were

recognizable in the proceeding for reorganization. And recognizing such claims in that manner, the Corporation and the Trust Fund were insolvent and unable to pay their debts as they matured.

The sufficiency of the petition for reorganization is challenged upon the ground that it failed to allege that the Corporation and the Trust Fund were insolvent or unable to pay their debts as they matured. Section 127 of Chapter X, 11 U. S. C. § 527, provides that a petition for reorganization may be filed in a pending bankruptcy proceeding, either before or after the adjudication of the Corporation. And Section 130(1), 11 U. S. C. § 530(1), provides that every petition for reorganization shall state that the corporation is insolvent or unable to pay its debts as they mature. The petition in this case did not state in specific language that the Corporation and the Trust Fund were insolvent or unable to pay their debts as they matured. And it was not filed in the bankruptcy proceeding. It took a different number on the docket of the court. But in the petition direct reference was made to the pending proceeding in bankruptcy. That proceeding was identified by number and style. And it was stated in the petition for reorganization that the court had determined in the bankruptcy proceeding that the relation of debtor and creditor existed beween the Trust Fund and the holders of certificates. It was further stated that outstanding certificates evidencing interests in or claims against the Trust Fund aggregated $39,038,139.91; and that the book value of the assets of the Trust Fund as determined by an audit of the accounting firm of Ernst & Ernst totaled in amount $28,848,791.13. And a copy of the balance sheet compiled and prepared by the auditors was attached to the petition and made a part of it. Such balance sheet disclosed assets and liabilities in the amounts stated, respectively. It was further stated in the petition that owners of certificates were entitled to have

their certificates redeemed at any time after three years from issuance upon the basis of their proportionate part of the trust fund, either in cash or in kind; that due to the multi-type and varied classes of investments of the Trust Fund, it was impossible to make division in kind; that it was impossible without liquidating the Trust Fund to pay each certificate holder his proportionate part thereof; and that to liquidate the assets of the Trust Fund would cause great loss and irreparable damage. Although the petition failed to state in categorical terms that the Corporation and the Trust Fund were insolvent or unable to pay their debts as they matured, the fact clearly appeared from the face of the pleading, the involuntary petition in bankruptcy, the report of the audit, and the balance sheet, all of which were specifically referred to in the petition for reorganization. Therefore the petition was not fatally defective for failing to comply with the requirements of Section 130(1), *supra*. Neither was it fatally infirm in other respects.

Error is predicated upon the declination of the court to conduct a hearing upon the issues tendered by the O'Bryans and the Harts in their respective pleadings. In such pleadings, the action of the court in entering its order of adjudication in bankruptcy and in entering its order approving the petition for reorganization under Chapter X was challenged upon the ground that the Corporation and the Trust Fund were separate legal entities; that the relationship of debtor and creditor did not exist between the Corporation and the Trust Fund on one hand, and the holders of certificates on the other hand; and that the Corporation and the Trust Fund were not insolvent or unable to pay their just debts as they matured. Section 144 of Chapter X, 11 U. S. C. §544 provides in substance that if a creditor, indenture trustee, or stockholders shall file an answer controverting any of the material allegations contained in the petition, the judge shall determine the issues presented, and enter an order approving the petition if satisfied that

Office-Supreme Court, U.

it complies with the requirements of the chapter, that it was filed in good faith, and that the material allegations are sustained by the proofs, or dismiss it if not so satisfied. The court should have given the O'Bryans and the Harts an opportunity to adduce evidence in support of the issues of fact tendered in their pleadings. But the issues of fact tendered by these parties had been injected into the proceeding by others at an earlier juncture. Evidence had been adduced relating to such issues and they had been determined. Any additional evidence which the O'Bryans and the Harts might have presented would have been merely cumulative and repetitive with no persuasive indication that the action of the court in determining such issues would have been different in the end. The declination to hear further evidence did not prejudice the O'Bryans and the Harts in their effort to overturn the action of the court in entering the order of adjudication in bankruptcy and in entering the order approving the petition for reorganization; and to vacate such action of the court and remand the proceeding for the idle purpose of enabling such parties to adduce cumulative or repetitive evidence would merely prolong the complicated litigation without resulting change in the ultimate outcome.

The orders from which the appeals were taken, respectively, are severally

AFFIRMED

Appendix B—Judgment and Order Denying Rehearing

Judgment

Thirtieth Day, September Term, Tuesday, October 14th, 1958.

Before HONORABLE SAM G. BRATTON, Chief Judge, and HONORABLE JOHN C. PICKETT and HONORABLE JEAN S. BREITENSTEIN, Circuit Judges.

These causes came on to be heard on the transcript of the record from the United States District Court for the Western District of Oklahoma and were argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the orders of the United States District Court for the Western District of Oklahoma be and the same are hereby severally affirmed.

Order Denying Rehearing

Forty-Seventh Day, September Term, Monday, November 10th, 1958.

Before HONORABLE SAM G. BRATTON, Chief Judge, and HONORABLE JOHN C. PICKETT and HONORABLE JEAN S. BREITENSTEIN, Circuit Judges.

These causes came on to be heard on the petition of appellants for a rehearing herein and were submitted to the court.

On consideration whereof, it is ordered by the court that the said petition be and the same is hereby denied.

APPENDIX C

Opinion of State Court

SELECTED INVESTMENTS CORPORATION,
Plaintiff in Error,

—v.—

OKLAHOMA TAX COMMISSION,
Defendant in Error.

No. 36731.

SUPREME COURT OF OKLAHOMA

March 12, 1957

Rehearing Denied April 2, 1957

Appeal from the District Court of Oklahoma County; Albert C. Hunt, District Judge.

Action by Selected Investment Corporation, a taxpayer, against Oklahoma Tax Commission for refund of income taxes paid under protest against legality of the assessment of such tax and for statutory interest thereon. Judgment for defendant, and plaintiff appeals. Reversed and remanded with directions.

WELCH, Chief Justice.

To the income tax on the income tax return of the plaintiff, Selected Investment Corporation, for 1948 the Oklahoma Tax Commission in effect made or applied an added assessment on the sum of $543,215.35 earned by investments of money from the Selected Investment Trust Fund.

"Commission" contends this sum was an earning and income of Selected Investment Corporation, while "Cor-

poration" contends it did not own the Trust Fund nor its earnings or income, and that the sum mentioned was the earnings and the income of "Trust Fund" as a separate legal entity, and that therefore such income is not taxable to plaintiff corporation.

The controversy first presents the question: Whether "Corporation" and "Trust Fund" are separate legal entities, and whether the income here involved was in fact and law the income of "Corporation" or the income of "Trust Fund" as a separate legal entity.

In considering that question we must examine the structure, ownership and operation of "Trust Fund" and of "Corporation." The Selected Investment Corporation was created by incorporating under Oklahoma Laws, and by receiving its charter as an Oklahama Corporation. It is owned by its corporate stockholders and operated by its officers and Board of Directors in the usual manner of a corporation.

It was stipulated by the parties that "Corporation" was incorporated in 1930, and that the Articles of Incorporation as filed in the Secretary of State's office provided:

> "• • • that the purposes for which the corporation is formed are to transact a general investment business, to create, manage and supervise under indentures or other contractual relationships, investments, trust funds, and the cash securities therein, and to issue certified bonds as evidence of the separate revocable trusts or participating interests, the holders of such certificates before any such funds are created, managed or supervised to designate the trustee therefor, to enter into, may perform and carry out contracts with any corporation so as to permit that person to buy, sell, hold, and deal in all kinds of listed and unlisted securities, and to loan money on real and personal property."

Appendix C—Opinion of State Court

One of the business operations of "Corporation," or perhaps its principal business, was the management of trust funds as it was specifically authorized to do.

Now the structure, creation and operation of "Trust Fund" was about as follows: By advertising and soliciting, individuals were induced to make cash investments. The money so advanced, less a stated or agreed percentage to "Corporation" for its initial fee and or expense was to be and was in fact deposited in a separate fund or deposit in a designated bank as a trust fund owned by the investors therein, the bank being designated as trustee thereof. This was done and "Trust Fund" was thereby created and implemented pursuant to a contract or indenture providing at length and in great detail for the trustee to receive the money and for the handling and operation of "Trust Fund." Provision was made for changing of the trustee in case the first trustee wanted to resign, or in case of certain other eventualities with provision for bonding the trustee. Each investor who advanced money to invest in, and thus to build up, "Trust Fund" was issued a certificate showing his investment, referring to the original trust agreement or indenture and making the investor a party thereto, and thereby the investor was made an owner of his proportionate share of the "Trust Fund." There was provision for the investor certificate holder to revoke the trust as to his part or share and to withdraw therefrom and to surrender his certificate and receive payment of his share in the fund of the value of his proportionate share at that time. It was the money so advanced to such fund and so deposited in trust which created and constituted "Trust Fund."

The indenture or trust agreement provided that "Corporation" would manage and direct investments from "Trust Fund." The trustee had no authority to make investments from the trust fund or expenditure therefrom except such as were directed by "Corporation." The plan

was that "Corporation" would select stocks and bonds or certain other properties or property interests or mortgages to be purchased for "Trust Fund" and held for income and interest to "Trust Fund," and for possible increase in value. Such stocks and bonds or other properties were the property of "Trust Fund." The purchase price therefor was paid by the trustee out of "Trust Fund" upon the direction of "Corporation." All income from any such stocks or bonds or other property interest went into "Trust Fund" and upon sale of any such items the sale price or money received therefor went into "Trust Fund." There was provision for certain periodical returns to be paid to the investor certificate holders out of "Trust Fund," and after such payment requirements had been fully met from earnings or income received by "Trust Fund" from its investments or purchases, then "Corporation" was to receive from "Trust Fund" a stated compensation or management fee for its services in managing "Trust Fund." This fee, as collected or received for managerial services, was income to "Corporation" and was so reported along with other income, if any, of "Corporation," and tax thereon paid. As to that, we do not understand it was contended otherwise. When stocks or bonds or other property items were purchased out of moneys in "Trust Fund" they were held by or for "Trust Fund's" benefit. When any such items were sold for profit, such profit did not go to "Corporation" but went to "Trust Fund" for its benefit or to or for the beneficial owners of "Trust Fund," that is, the certificate holders.

We think it is apparent that when money was accumulated in "Trust Fund," nothing was thereby added to the assets of "Corporation." When stocks or bonds or other property interests were so purchased as aforesaid there was no change in the assets of "Corporation." If stocks or bonds so purchased increased substantially in value,

nothing was thereby added to the capital value or to the assets of "Corporation," but such increase in value inured to the sole benefit of "Trust Fund" and its beneficial owners. No income to "Trust Fund" or increase in value of its property investments was of any benefit to "Corporation" except insofar as it might percentage-wise effect the amount of compensation or management fee payable to "Corporation."

Over the years since 1930 many thousand investors had entered into and contributed to this plan of business venture. Many had received the returns promised at regular intervals and many had cashed out their certificates at a profit. In 1951 to 1953 when "Commission" made and charged and collected this added assessment against "Corporation" there were between six and seven thousand certificates outstanding against "Trust Fund" in varying amounts representing the aggregate contributions of about $23,000,000 to "Trust Fund."

While the business done was large, with very substantial profits and income, we do not understand that any of it was received into the assets of "Corporation" except its stipulated management fee based on stated percentage.

This overall plan was certainly designed and stated on paper to create two separate legal entities, one entity being the "Trust Fund" to receive and hold all moneys and property interests and income therefrom for its beneficial owners, and the other entity being "Corporation" which for stated and agreed compensation managed the assets of "Trust Fund," but did not own them; and we are convinced that the day to day operations maintained the stated purpose and design of preserving the two separate legal entities.

We do not observe any contention that there is any law violation, or any illegality in the Articles of Incorporation or in the Indenture or Trust Agreement above referred to, or in the conduct of these business ventures.

As we understand it, these two entities maintained completely separate books and records and there was no commingling of books or records or moneys or assets. "Corporation" made no contribution to "Trust Fund" except by way of services rendered, and "Corporation" did not take or receive anything from "Trust Fund" except its stated and agreed compensation or fee for services rendered.

It is the position of "Corporation" that the earnings or income of "Trust Fund" are taxable, if at all, to "Trust Fund," wholly separate from the income of "Corporation," or that such earnings or income are taxable to the owners or certificate holders, and are in no event assessable against "Corporation." It is pointed out that this has been the position taken since 1930, and it is pointed out that "Commission" has accepted this view for a number of years and up to 1948.

In Oklahoma Tax Commission v. Liberty National Bank & Trust Co., Okl., 289 P. 2d 388, this court held in effect that where the Oklahoma Tax Commission had since 1931 interpreted tax statutes as authorizing banks to use the reserve for bad debts method of writing off bad debts, such consistent administrative interpretation of the tax statute would prevail over the contrary interpretation suggested by "Commission" for the first time more than twenty years later. We find the principle there followed to be applicable here.

[1] No case exactly in point with the question here involved is cited by either party. Consistently separate entities are recognized for tax purposes. This is so by statute, recognizing as separate entities, individuals, corporations, partnerships, trusts and estates, 68 O. S. 1951 § 874, and by actions and decisions of taxing authorities and courts. At all times the labor has been to determine to which entity the income should be charged or taxed. See Jones v. Norris,

10 Cir., 122 F. 2d 6; Moline Prop., Inc., v. Commissioner of Internal Revenue, 319 U. S. 436, 63 S. Ct. 1132, 87 L. Ed. 1499, 1502; Burnet v. Commonwealth Improvement Co., 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399. Many other cases are cited by both parties where the courts labored with the same problem under various and varying circumstances. We think we need not cite or discuss those additional authorities further than to say that the court in each such case was called upon to determine, under the facts in each case, which entity actually earned and received the income and should be taxed thereon, with the decision in each case finally resting on the particular facts peculiar to each case.

"Commission" here emphasized the rule that "it is well settled law that a taxpayer cannot avoid taxes by employing a sham or subterfuge" and supporting cases are cited. We fully agree with that rule, but we cannot find that the business arrangement here is or results in a sham or subterfuge to avoid taxes, or in any sham or subterfuge at all. There is nothing to show that this business method or plan was designed or followed for any wrongful or unwholesome purpose.

[2] We find and hold that it is well shown that "Corporation" and "Trust Fund" are separate entities, and that the items here involved constituted income to "Trust Fund" not taxable to "Corporation." Therefore the trial court erred in its holding, and reversal of its judgment must follow.

There is substantial discussion as to which item, or whether certain items are deductible in the income and tax calculation made by "Commission" in the reassessment here made against "Corporation," but since no such assessment may be properly made against "Corporation" on the income items here involved, we need not consider what the "Commission" might or should allow or determine as to deductions.

Reference is made to a specific sum of $53,714.92, and "Commission" emphasizes the fact that this sum could have been charged by and paid to "Corporation" on its management fee, but instead that it was retained by or left in "Trust Fund" to aid it in redeeming certificates at par and a market for the sale of same thusly maintained. We deem this to be wholly unimportant to our determination here, since this sum was merely a part of the over-all sum earned in the first place by investments from "Trust Fund," and became and was an asset of "Trust Fund" like all other moneys remaining in the "Trust Fund" for the benefit of its owners, the holders of the certificates above mentioned.

The judgment appealed from is reversed, and the cause remanded with directions to render judgment for "Corporation."

WELCH, *C. J.*, CORN, *V. C. J.*, and DAVISON, JOHNSON, WILLIAMS and CARLISLE, *JJ.* concur.

BLACKBIRD and JACKSON, *JJ.*, dissent.

JACKSON, *Justice* (dissenting).

As I understand the majority opinion it holds that the "Trust Fund" here involved is a separate entity from Selected Investments Corporation and that the income from the Trust Fund is the income of the Trust Fund and therefore taxable against the Trust Fund.

The Contract or "Indenture" between the Corporation (Selected Investments Corporation), the Trustee, and the Certificate holders provides the original Trustee, appointed by the Corporation, will serve until such time as he may resign, or be removed by order of the Corporation, or by an instrument signed by more than 50% of the holders of the total face value of all certificates outstanding. In the event of removal or resignation of the Trustee his successor

will be appointed by the Board of Directors of the Corporation. The duties of the Trustee are to keep the cash and securities constituting the investment or Trust Fund, and to authenticate certificates. He is a custodian, performing only such functions as directed by the Corporation or provided in the Indenture. He receives and pays out money and makes investments as directed by the Corporation. He liquidates the investments when directed by the Corporation. He exercises no independent judgment in matters of policy. His duties are ministerial in nature to be performed as and when directed by the Corporation. His compensation is provided for in the Indenture and is based upon a small percentage per annum of the Investment Trust Funds.

As to the income earned by the investment of the Trust Fund in 1948, I am of the opinion it is immaterial whether the Trust Fund is a separate entity from the Corporation. Although the earned income resulting from the investment of the Trust Fund is collected by the Trustee and placed in the Trust Fund it is not the income of the Trust Fund.

Before an investor buys or invests in a "Trust Certificate Bond" he signs a purchase agreement. The purchase agreement provides that he is bound by the terms of the Indenture. The Indenture provides the Corporation will manage his investment. It further provides that corporation may charge on the last day of each half year of the fiscal year, as compensation for its services, a sum not greater than 2% of the aggregate actual value as of the last day of each half year of all shares represented by outstanding certificates on said last day of such half year. The Indenture further provides, however, that such compensation (2% as above) for management services shall not be levied against the Trust Fund until the certificate holders shall have received dividends at the rate of 6% per annum accumulative on their respective shares of the fund. In the event of liquidation of the Trust Fund the Indenture

provides that those holding Trust Fund Certificates, at the time of liquidation, shall share ratably in any surplus earnings that may have accrued in the Trust Fund. Thus it is apparent that the holders of Trust Fund Certificates have a contract right to receive each year the earned income of the Trust Fund up to 6%, or any earned fraction thereof. The Corporation has a contract right to charge 2% twice each year for its services, after the Certificate holders have first received their 6%.

As I view the Indenture it is immaterial whether the return to the investor is called "interest" or "dividends," or that the return to the investor may be less than 6% per year. There is a fixed contractual obligation on the part of the Corporation and the Trustee to pay out to the investor or Certificate holder the first 6%, or fraction thereof, that is earned by the investment of the Fund. Thus the Certificate holder is the only person who has made any profit on the investment of the Fund if only 6%, or less, is earned during the year by the investment of the Fund. Since the Certificate holder is the only person receiving any profit, and the Corporation and Trustee are under a contractual obligation to pay it, I am of the opinion that the Certificate holder is under duty to pay income tax on the earnings of his investment, whether it be called "interest" or a "dividend."

In 1948, after paying the Certificate holders 6% on their investments, the Corporation declined to claim all of its percentage or authorized compensation for its management services, but left $53,714.92 in the Trust Fund to create a surplus. Undoubtedly, under the Indenture, this was income earned by the Corporation for its management services upon which it should pay income tax. In leaving this $53,714.92, as a surplus, in the Trust Fund the Corporation made a gift to their Certificate-holders to be paid out in 1949, or subsequent years, in the form of "interest" or "dividends."

For the foregoing reasons, I must respectfully dissent.